December 15, 2015

MEMORANDUM TO: Board of Directors

FROM: Bret D. Edwards Bret D Edwards
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SUBJECT: Notice of Proposed Rulemaking Regarding the Orderly Liquidation of Covered Brokers or Dealers under the Provisions of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act-12 C.F.R. Part 380

RECOMMENDATION: That the Board of Directors (the "Board") of the Federal Deposit Insurance Corporation (the "FDIC") approve the publication of the attached Notice of Proposed Rulemaking (the "proposed rule") titled *Covered Broker-Dealer Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.* If the publication of the proposed rule is approved by the Board and a substantially-identical proposed rule is approved by the Securities and Exchange Commission (the "SEC"), the proposed rule would be published in the *Federal Register* for a 60-day public comment period.

INTRODUCTION: Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (12 U.S.C. 5301 *et seq.*) (the "Dodd-Frank Act" or "Act") provides the authority for the appointment of the FDIC as receiver to conduct the orderly liquidation of systemically-important financial companies. Section 205 of Title II of the Act sets forth certain provisions specifically relating to the orderly liquidation of systemically-important brokers or dealers. Section 205(h) of the Act requires the FDIC and the SEC, in consultation with the Securities Investor Protection Corporation ("SIPC"), jointly to issue rules to implement section 205.

DISCUSSION:

I. General Background:

Under normal circumstances, the liquidation of a broker or dealer would be subject to the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa-*lll*) ("SIPA"). SIPA provides for a court-supervised liquidation of a broker or dealer by SIPC or a trustee appointed by SIPC.

The process by which a broker or dealer may be placed into orderly liquidation under Title II is set forth in section 203 of the Act. In the case of a broker or dealer (or where the largest U.S. subsidiary of a financial company is a broker or dealer) the Board of Governors of the Federal Reserve and the SEC are authorized to issue a written orderly liquidation recommendation to the U.S. Treasury Secretary (the "Secretary"). The FDIC must be consulted in such a case. The recommendation, which may be *sua sponte* or at the request of the Secretary, must contain a discussion of the eight criteria enumerated in section 203(a)(2) of the Act (including that the liquidation of the broker or dealer under SIPA would have serious adverse effects on financial stability in the U.S.) and be approved by a vote of at least two-thirds of each agency's governing body then serving. Based on similar but not identical criteria, the Secretary would consider the recommendation and (in consultation with the President) determine whether the broker or dealer poses a systemic risk requiring liquidation under Title II. Upon the Secretary's determination, a broker or dealer would be placed into an orderly liquidation proceeding and the FDIC would be appointed as receiver. A broker or dealer for which such a systemic risk determination is made is a "covered broker or dealer."

The proposed rule would (i) clarify how the relevant provisions of SIPA would be incorporated into a Title II proceeding, (ii) specify the purpose and content of the application for a protective decree required by section 205 of the Act, (iii) clarify the FDIC's powers as receiver with respect to the transfer of assets of a covered broker or dealer to a bridge broker or dealer, (iv) specify the roles of the FDIC as receiver and SIPC as trustee with respect to a covered broker or dealer, (v) describe the claims process applicable to customers and other creditors of a covered broker or dealer, including the interaction of the determination of customer claims under SIPA with the Title II claims process, (vi) provide for SIPC's administrative expenses and (vii) provide that the treatment of qualified financial contracts ("QFCs") of the covered broker or dealer is governed exclusively by section 210 of the Dodd-Frank Act.

II. The Role of SIPC and SIPA in a Title II Orderly Liquidation of a Broker or Dealer:

The orderly liquidation of a systemically important covered broker or dealer under Title II seeks to avoid or mitigate the serious adverse effects on financial stability in the U.S. that would result from the liquidation of the broker or dealer under SIPA while ensuring that customers of a covered broker or dealer have protections comparable to the protections provided to them under SIPA. *See* sections 203(b)(5) and 204(a) of the Act. Section 205 of the Act provides for an important role for SIPC in a Title II orderly liquidation of a covered broker or dealer and incorporates many substantive provisions from SIPA into Title II. For example, section 205(a)(1) of the Act requires that, upon the appointment of the FDIC as receiver for a covered broker or dealer, the FDIC shall appoint SIPC "to act as trustee for the liquidation under

[SIPA] of the covered broker or dealer." Section 380.61 of the proposed rule would require that the FDIC appoint SIPC as trustee for the covered broker or dealer, but would omit the phrase "for the liquidation under SIPA" to reflect the fact that there is no proceeding under SIPA; rather the covered broker or dealer is being liquidated under Title II.

In addition, other provisions of section 205 of the Act clearly establish that SIPA principles apply in a Title II orderly liquidation relating to a covered broker or dealer. SIPC, as trustee for the covered broker or dealer, together with the FDIC, as receiver, are tasked with determining and satisfying claims against the covered broker or dealer consistent with *both* Title II and SIPA. *See* section 205(a)(2)(D) of the Act. Upon its appointment as trustee, SIPC shall have all of the powers and duties provided by SIPA and shall conduct the liquidation of the covered broker or dealer in a manner consistent with the terms of SIPA. *See* section 205(b)(1) of the Act. Most importantly, under SIPA, the claims of customers (generally any person who has a claim on a broker or dealer on account of securities held by the broker or dealer)[1] with respect to their property, including cash and securities, receive priority over the claims of general creditors. This preference for customers is incorporated into Title II; customers of a covered broker or dealer must receive payments or property "at least as beneficial" to them as would have been the case had the covered broker or dealer been liquidated under SIPA.[2] The proposed rule would effectuate this protection of customers by assuring that the process for determining and satisfying customer claims meets this standard with respect to the manner and amount of proceeds realized by customers as a result of the liquidation of the covered broker or dealer under Title II.

The proposed rule would address many of the customer protection features of SIPA that were incorporated by the Dodd-Frank Act into Title II with respect to the orderly liquidation of a

[1] The term "customer" in the proposed rule has the same meaning as in SIPA. *See* 15 U.S.C. 78*lll*(3).
[2] *See* section 205(f)(1) of the Act.

covered broker or dealer, therefore it may be helpful to provide a brief description of how customer claims are handled in a typical SIPA proceeding.

III. Liquidation of Brokers and Dealers Under SIPA:

An integral part of the SIPA broker or dealer customer protection regime is the preferred status of customers of the broker or dealer relative to other creditors with respect to customer property (generally all customer related property held by the broker or dealer).[3] In a SIPA proceeding customer accounts and associated customer property generally are handled in one of two ways. First, they may be sold or otherwise transferred to another broker or dealer that is a SIPC member. Such account transfers are separate from the claim process. These customer account transfers are useful in that they allow customers early access to their accounts, allow customers to resume trading more quickly and minimize disruptions in the securities markets. If it is not practicable to transfer the accounts, then the alternative way to return customer property to the control of customers is through the customer claims process. Under court supervision, the SIPA trustee calculates each customer's net equity (which, in general terms, is the dollar value of a customer's accounts minus the amount of any loans made by the broker or dealer to the customer)[4] and the total amount of customer property available for distribution to all customers. Each customer will be entitled to a ratable share of customer property based on its net equity. Once the SIPA trustee determines the total fund of customer property and the total of all customer net equity claims, the trustee can establish each customer's pro rata share of the customer property. Customer net equity claims are generally satisfied to the extent possible by providing the customer with securities identical to those owned by that customer on the filing date. Under certain circumstances, if there is a shortfall in customer property, a customer may be

[3] The term "customer property" in the proposed rule has the same meaning as in SIPA. *See* 15 U.S.C. 78*lll*(4).
[4] The terms "net equity" and "customer property" in the proposed rule have the same meaning as in SIPA. *See* 15 U.S.C. 78*lll*(11) and 78*lll*(4).

entitled to payments from SIPC up to the amount of $500,000 ($250,000 for cash assets). These payments from SIPC are generally made by providing securities identical to the missing securities rather than through the payment of cash. As a SIPA proceeding is under court supervision, customers who are not satisfied with any of SIPC's determinations (including determinations of customer status, net equity and the allocation of customer property) can file an objection with the court or commence a lawsuit against SIPC or the trustee appointed by SIPC.

IV. Orderly Liquidation of a Covered Broker or Dealer Under the Proposed Rule:

As noted above, the proposed rule would harmonize and clarify the integration of applicable SIPA principles into Title II in a manner that is consistent with Title II's requirement that customers of a covered broker or dealer receive payments or property at least as beneficial to them as would have been the case had the covered broker or dealer been liquidated under SIPA. An important first step in both the Title II process and the SIPA process is the filing of an application for a protective decree.

A. Application for Protective Decree:

Section 205 of the Act requires that upon the appointment of SIPC as trustee for the covered broker or dealer, SIPC file an application for a protective decree with a federal district court and SIPC and the FDIC, in consultation with the SEC, jointly determine the terms of the protective decree to be filed. The purpose of a protective order in a SIPA proceeding is to obtain a court order terminating any other proceeding under the Bankruptcy Code and ordering various stays on the exercise of creditors' rights.

Such a court order is not necessary in connection with an orderly liquidation under Title II since the Act itself provides all necessary stays and provides for dismissal of any case under the Bankruptcy Code or SIPA upon notice to the bankruptcy court and SIPC. To give effect to the statutory requirement and at the same time provide useful and valuable information to customers and creditors of the covered broker or dealer, section 380.62 of the proposed rule would clarify that the purpose of the application for a protective order in a Title II proceeding is to give notice to interested parties that an orderly liquidation process has been initiated. The proposed rule would recommend a non-exclusive list of information drawn from Title II to be included in the protective order so that interested parties who may not be familiar with the orderly liquidation authority have key information about the Title II process. This information would include a brief description of the relevant statutory stays and notice of the dismissal of any pending insolvency proceedings with respect to the covered broker or dealer. In addition, the proposed rule would clearly identify the federal district court where the application for a protective decree would be filed in order to make it easier for interested parties to locate the filing.

B. Formation of a Bridge Broker or Dealer and Transfers of Customer Property and Other Assets and Liabilities of a Covered Broker or Dealer:

Title II of the Dodd-Frank Act sets forth the powers of the FDIC as receiver for a covered financial company,[5] including a covered broker or dealer. One such power is the power to organize bridge financial companies, including, under section 210(h)(2)(H) of the Act, bridge brokers or dealers. Section 380.63 of the proposed rule would address the formation of bridge brokers or dealers consistent with the Act. The proposed rule would make it clear that if the FDIC organizes a bridge broker or dealer, all customer accounts and all associated customer name securities and customer property must be transferred to the bridge broker or dealer, unless (i) the transfer of the accounts to another broker or dealer would likely be "promptly"

[5] A "covered financial company" means a financial company for which a systemic risk determination has been made under section 203(b) of the Act.

consummated or (ii) the transfer would materially interfere with the Corporation's ability to mitigate adverse systemic effects of the failure.[6] Section 210(h)(5) of the Act provides that the FDIC as receiver may transfer any other assets of the covered broker or dealer to a bridge broker or dealer as it may in its discretion determine to be appropriate, subject only to certain limitations contained in the Act. Section 380.63(b) of the proposed rule would give effect to section 210(h)(5) of the Act and would permit the receiver to transfer such assets and liabilities as it deems appropriate and would help the receiver maintain critical operations of the covered broker or dealer, protect customer assets and preserve financial stability.

Under the proposed rule, customer accounts would be transferred to the bridge broker or dealer only up to the amount of allocated customer property together with any SIPC payments. Liability for any shortfall would remain in the receivership estate, and customers would have claims against any remaining receivership assets with respect to such shortfall. Under section 380.63(d) of the proposed rule, a customer's net equity claim would be deemed to be satisfied to the extent that customer property of the covered broker or dealer, along with property made available through advances from SIPC, is transferred and allocated to the customer's account at the bridge broker or dealer. Section 380.63(d) of the proposed rule also would provide that allocations to customer accounts at the bridge broker or dealer may initially be based on estimates derived from the books and records of the covered broker or dealer or other information deemed relevant by the FDIC as receiver, in consultation with SIPC, as trustee. This approach is based upon experience with SIPA liquidations where, for example, there were difficulties reconciling the broker or dealer's records with the records of central counterparties or other counterparties or other factors that caused delay in verifying customer accounts. This provision of the proposed rule is designed to facilitate access to accounts for the customers at the

[6] *See* section 210(a)(1)(O) of the Act.

bridge broker or dealer in incremental amounts as soon as is practicable under the circumstances while facilitating the refinement of the calculation of allocations of customer property to customer accounts as additional information becomes available. This process would help ensure that customers have access to their customer accounts as quickly as practicable, that customer property and payments from SIPC would be fairly and accurately allocated and that any remaining claims would be left with the receivership to be paid from non-customer property.

Section 380.63(e) of the proposed rule would provide for the transfer of assets or liabilities from a covered broker or dealer to a bridge broker or dealer without any consent, authorization or approval of any person or entity, including, but not limited to any customer, contract party, governmental authority or court.[7] Congress recognized that, in order to ensure financial stability in the U.S. following the failure of a covered financial company, the FDIC as receiver must be free to determine which assets and liabilities of the covered financial company are to be transferred to a bridge financial company, and to transfer such assets and liabilities expeditiously and irrespective of whether any other person or entity consents to or approves of the transfer.

C. Determinations with Respect to Customers and Calculation of a Customer's Net Equity:

Under section 380.64(a)(3), the FDIC, as receiver, in consultation with SIPC, as trustee, would allocate customer property and property made available through advances from SIPC in a manner consistent with SIPA and with SIPC's normal practices thereunder. The process for determining and satisfying customer claims would begin with a calculation of customers' net equity by SIPC, as trustee. This process is explained in section 380.64(a)(1) of the proposed rule

[7] *See* sections 204(c)(4), 210(a)(1)(O) and 210(h)(5)(D) of the Act. *See also* section 210(h)(2)(E)(ii) of the Act (providing that the bridge financial company may succeed to the rights, powers, authorities and privileges of the covered financial company).

which would provide that SIPC "shall determine customer status, claims for net equity, claims for customer name securities, and whether property of the covered broker or dealer qualifies as customer property." In doing so SIPC would "make claims determinations in accordance with SIPA . . . ."[8] In addition, section 380.64(a)(4) of the proposed rule would provide that "the allocation of customer property, advances from SIPC and delivery of customer name securities to each customer or to its customer account at a bridge broker or dealer . . . shall be in a manner, including form and timing, and in an amount at least as beneficial to such customer as would have been the case had the covered broker or dealer been liquidated under SIPA." These provisions, when taken together, are designed to meet the Act's mandate that customers receive payments or property at least as beneficial to them as would have been the case had the covered broker or dealer been liquidated under SIPA.

D. Roles of Receiver and SIPC as Trustee:

The proposed rule also would clarify the roles of the FDIC as receiver and SIPC as trustee with respect to a covered broker or dealer. Section 380.64 of the proposed rule would provide that SIPC as trustee shall determine customer status, net equity, the scope and amount of customer property and claims for delivery of customer name securities and make advances in accordance with SIPA. The FDIC as receiver would oversee the claims process for all claims and determine all non-customer claims. In addition to ensuring that customer claims would be satisfied in a manner and amount at least as beneficial as if the covered broker or dealer had been liquidated under SIPA by using a process consistent with the process under SIPA, this approach would provide for the resolution of all non-customer claims in connection with the liquidation of the covered broker or dealer in a manner consistent with the priorities for the distribution of the assets of a covered broker or dealer specified in the Act.

[8] *See* section 380.64(a)(1) of the proposed rule.

E. Claims Process and Priorities:

Section 380.64 of the proposed rule would clarify the claims process by explaining the procedures for filing a claim, the function of the claims bar date and the time period for allowing or disallowing a claim. Section 380.64(b) would describe the FDIC's role as receiver of a covered broker or dealer with respect to claims, providing for the receiver's publication and mailing of notices to creditors of the covered broker or dealer as required by the Act, but in a manner consistent with both SIPA and the notice procedures set forth in 12 CFR 380.33 applicable to covered financial companies generally. It also would require notice to potential claimants of SIPC's appointment as trustee and provide for the receiver's consultation with SIPC regarding the procedures for filing a claim, including the form of claim and the filing instructions to facilitate a process that would be consistent with SIPC's general practices to the extent possible.

Section 380.64(b) of the proposed rule would establish the claims bar date as the date following the expiration of the six-month period beginning when notice to creditors is first published, which would be consistent both with 12 CFR 380.32 (which requires that the claims bar date be no less than 90 days[9] after first publication) and with SIPA (which provides for the barring of claims after the expiration of the six month period beginning upon publication). As required by section 210(a)(3)(C)(i) of the Act, the proposed rule would provide that any claim filed after the claims bar date would be disallowed, and such disallowance would be final, but for two statutory exceptions. The Act provides that a claim filed after the claims bar date shall be considered by the receiver if (i) the claimant did not receive notice of the appointment of the receiver in time to file such claim before the claims bar date, or the claim is based upon an act or

[9] Generally the FDIC sets the claims bar date at 90 days under the comparable provision of the Federal Deposit Insurance Act, however we expect to use the shorter bar date in other Title II contexts.

omission of the receiver that occurs after the claims bar date has passed and (ii) the claim is filed in time to permit payment (i.e., before a final distribution is made by the receiver), as provided by 12 CFR 380.35(b)(2). This exception for late-filed claims serves a similar purpose (i.e., to ensure a meaningful opportunity for claimants to participate in the claims process) as the "reasonable, fixed extension of time" that may be granted to the otherwise applicable six-month deadline under SIPA to certain specified classes of claimants. Additionally, in accordance with SIPA, section 380.64(b) of the proposed rule would provide that any claim for net equity filed more than 60 days after the notice to creditors is first published need not be paid or satisfied in whole or in part out of customer property and, to the extent such claim is paid by funds advanced by SIPC, it would be satisfied in cash or securities, or both, as SIPC, as trustee, determines is most economical to the receivership estate. The proposed regulation explicitly would adopt a provision of SIPA that requires a claim to be filed within 60 days of the date of appointment of the receiver[10] in order to assure the payment of customer claims through the allocation of customer property. Later filed claims filed prior to the bar date may be satisfied in cash or securities, or both, as SIPC determines is most economical to the estate.

Section 380.64(c) of the proposed rule would require the receiver to notify a claimant whether it allows or disallows a claim within the 180-day time period set forth in 12 CFR 380.36, including any extension of time by written agreement as provided therein. While the Dodd-Frank Act provides for expedited determination of certain types of claims (which may include customer claims for customer property), it would be impossible to actually provide expedited determination for any one customer. As a result of SIPA's *pro rata* requirement, in order to calculate any one customer's share of customer property, SIPC needs to know the claims of all customers to customer property. Therefore, the proposed rule would provide that the

[10] Under SIPA, the relevant date is the filing date of the commencement of the proceeding.

expedited claims process is not available to customers and the process established for the determination of claims by customers of a covered broker or dealer for customer property or customer name securities would constitute the exclusive process for the determination of such claims. Hence, the process would ensure compliance with SIPA's requirement that customer claims to customer property be determined *pro rata* based on each customer's net equity applied to all customer property as a whole. While the receiver would send the allowance or disallowance of any claim to the claimant, it would utilize the determinations made by SIPC, as trustee, with respect to any claim for net equity or customer name securities.

Under section 380.64(d) of the proposed rule, any customer claim that is denied in whole or in part by the receiver, including but not limited to any claim denied in whole or part based on any determination make by SIPC, would be subject to *de novo* judicial review. The proposed rule would make it clear that such judicial review would cover all determinations relating to the claim including determinations of customer status and security, preference, setoff or priority.

Section 380.65 of the proposed rule would address the special priorities applicable to unsecured creditor claims with respect to a covered broker or dealer, including claims for unsatisfied net equity of a customer. First, administrative expenses of SIPC as trustee for a covered broker or dealer (see discussion immediately below) would be reimbursed *pro rata* with administrative expenses of the FDIC; second, amounts paid by the FDIC to customers or SIPC would be reimbursed on a *pro rata* basis with amounts owed to the United States; and third, amounts paid by SIPC would be reimbursed subsequent to amounts owed to the United States but before any other claims.

F. SIPC's Administrative Expenses:

Section 380.66 of the proposed rule would provide that in carrying out its responsibilities as trustee for a covered broker or dealer, SIPC may utilize the services of private professionals. SIPC would have an allowed claim for administrative expenses for any amounts paid by SIPC for such services to the extent that the utilization of such services is practicable, efficient and cost effective. This would subject SIPC's use of outside services to the same standards as the FDIC's use of outside services. SIPC's allowed claim for administrative expenses for such services would be included as administrative expenses of the receiver and would be paid *pro rata* with all other administrative expenses of the receiver.

G. Qualified Financial Contracts:

Section 205(b)(4) of the Act states that "[n]otwithstanding any provisions of [SIPA]. . . the rights and obligations of any party to a [QFC] to which a covered broker or dealer . . . is a party shall be governed exclusively by section 210 [of the Act], including the limitations and restrictions contained in section 210(c)(10)(B)." The proposed rule would reflect this statutory directive in section 380.67 and follows the statutory text. Thus, as in the case of any covered financial company, the receiver for a covered broker or dealer would have the benefit of the one-day stay during which no party to a QFC may exercise any right it might have to terminate, liquidate, or net any QFC with the covered broker or dealer solely by reason of or incidental to the appointment of the FDIC as receiver. In addition, in transferring any QFC's to a bridge broker or dealer, the receiver would be required to transfer all QFCs between a person (or any affiliate of such person) and the covered broker or dealer or (ii) transfer none of the QFCs of such person (and any affiliate of such person).[11] Under section 210(c)(10)(A) of the Act, the

[11] In addition, if any QFC is transferred all claims relating to such QFC and all property securing or other credit enhancement for such QFC must also be transferred. *See* sections 210(c)(9)(A)(i)(II), (III) and (IV) of the Act.

FDIC must provide notice of any such transfer to any affected counterparty no later than 5:00pm (eastern time) on the business day following the date of the appointment of the FDIC as receiver. The limitation on the enforcement of walkaway clauses contained in section 210(c)(8)(F)(i) of the Act and the limited suspension of payment or delivery obligations under QFCs contained in section 210(c)(8)(F)(ii) of the Act also would apply in an orderly liquidation under Title II of a covered broker or dealer in the same manner as with respect to any other covered financial company.

CONCLUSION: The staff recommends that the Board approve the publication of the Notice of Proposed Rulemaking titled "Covered Broker-Dealer Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act" in the *Federal Register* with a 60-day public comment period.

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